FILED
JUN 3 1946
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945. No. [redacted] 136

H. GATES LLOYD,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

JESSE R. FILLMAN,
WM. CLARKE MASON,
2107 FIDELITY-PHILA. TR. BLDG.,
PHILADELPHIA 9, PA.

OWEN BIDDLE,
CASPAR W. B. TOWNSEND,
1100 PROVIDENT TRUST BUILDING,
PHILADELPHIA 3, PA.
Counsel for the Petitioner.

ALLEN, LANE & SCOTT, PRS., PHILADELPHIA.

INDEX.

PAGE

PETITION FOR WRIT OF CERTIORARI 1

Jurisdiction 2

Questions Presented 2

Reasons for Granting the Writ 2

Statement of the Matter Involved 3

BRIEF

Opinions Below 9

Jurisdiction 9

Statute Involved 9

Statement 10

Specifications of Error 10

Argument 11

Conclusion 14

Citations:

DECISIONS:

Beulah Eaton McAllister, 5 T. C. 714 11

Burnet *v.* Leininger, 285 U. S. 136 11

Clyde C. Pierce Corp. *v.* Commissioner, 120 F. (2d) 206 (C. C. A. 5th) 12

Commissioner *v.* Tower, No. 317, this Term 12

Gibson *v.* Commissioner, 133 F. (2d) 308 (C. C. A. 2d) 11

Griffiths *v.* Helvering, 308 U. S. 355 11

Harrison *v.* Schaffner, 312 U. S. 579 11

Helvering *v.* Horst, 311 U. S. 112 11

Hort *v.* Commissioner, 313 U. S. 28 11

Lucas *v.* Earl, 281 U. S. 111 11

Pollock *v.* Farmers' Loan & Trust Company, 157 U. S. 429; *id.*, 158 U. S. 601 ..... 3, 13

STATUTE:

Int. Rev. Code, Sec. 22(b)(4) 3, 9, 10, 11

MISCELLANEOUS:

T. D. 5507, Int. Rev. Bull., Apr. 22, 1946, page 2 11

G. C. M. 24849, Int. Rev. Bull., Mar. 11, 1946, page 4 11

I. T. 3795, Int. Rev. Bull., April 22, 1946, page 3 11

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945. No. .

H. Gates Lloyd,

Petitioner

v.

Commissioner of Internal Revenue,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

TO THE HONORABLE, THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your Petitioner, a resident of Haverford, Pennsylvania, respectfully petitions this Court for the issuance of a writ of certiorari to the Circuit Court of Appeals for the Third Circuit, to review the judgment of that Court entered on March 4, 1946, affirming a decision of The Tax Court of the United States entered on March 22, 1945.

A certified transcript of the portions of the record before the Circuit Court of Appeals at argument including the proceedings in the Circuit Court of Appeals, to-

gether with the requisite number of copies thereof, has been heretofore furnished in conformity with Rule 38 of this Court.

JURISDICTION.

This Court has jurisdiction to review the decision of the Circuit Court of Appeals in this case under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, chap. 229, Sec. 1, 43 Stat. 938; 28 U. S. C. A. Sec. 347(a). The judgment of the Circuit Court of Appeals was entered on March 4, 1946 (R. 106).

QUESTIONS PRESENTED.

1. Whether a holder of municipal bonds who detached interest coupons from the bonds and sold the coupons prior to their maturity is subject to income tax on the proceeds of the sale.

2. Whether the imposition of income tax on the proceeds of the sale of interest coupons detached from municipal bonds is prohibited by the Constitution of the United States.

REASONS FOR GRANTING THE WRIT.

1. The Circuit Court of Appeals for the Third Circuit, in holding that the proceeds of sale of "B" Coupons detached from bonds issued by the City of Philadelphia were not exempt from tax, decided an important question of Federal law which has not been, but should be, settled by this Court; and has decided the question in a way which is not in accord with decisions of this Court establishing the applicable principles of law.

2. The decision of the said Circuit Court of Appeals is in violation of the implied constitutional prohibition against impairment of the borrowing power of the several States and of political subdivisions thereof. *Pollock* v. *Farmers' Loan & Trust Company*, 157 U. S. 429; *id.*, 158 U. S. 601.

STATEMENT OF THE MATTER INVOLVED.

This case arises under Section 22(b)(4) of the Internal Revenue Code (53 Stat. 9; 26 U. S. C. A. Sec. 22(b)(4)), which provides for exemption from Federal income tax of "Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; * * *." During the year 1941 a partnership of which the Petitioner was a member shared in proceeds from the discount of interest coupons on bonds issued by the City of Philadelphia, Pennsylvania. The partnership reported its share of the proceeds as tax-exempt interest on its 1941 partnership return, and the Petitioner accordingly did not report any portion thereof as taxable income on his individual income tax return for that year (R. 74a, 75a). The Respondent determined that the proceeds from the discount of the interest coupons were not exempt from tax. He increased the income of the partnership, and increased the income of the Petitioner because of his interest in the partnership (R. 87a, 88a). The Tax Court sustained the Respondent's determination,[1] and the Circuit Court of Appeals affirmed the Tax Court (R. 106).

The City of Philadelphia in 1940 desired to refund some of its outstanding bonds in order to take advantage of low money rates then prevailing. Drexel & Co., a partnership of which the Petitioner was a member, and

[1] The decision of The Tax Court gave effect to a concession by the Respondent that a portion of the proceeds did constitute tax-exempt interest (R. 90a, 94a).

Lehman Bros. of New York City submitted a plan for the refunding of outstanding bonds of the City by exchange to a maximum principal amount of $131,064,000 (R. 78a, 79a, 80a). After consideration of several proposed plans, the City on June 9, 1941 adopted that submitted by Drexel & Co. and Lehman Bros. (R. 79a). A syndicate, known as "City of Philadelphia Refunding Bonds of 1941, Drexel & Co., Lehman Bros., Joint Account Managers" (hereinafter called "the Syndicate"), was formed to carry out the plan adopted by the City. Drexel & Co. became a member of the Syndicate (R. 76a).

The City of Philadelphia and the Syndicate entered into a contract known as the Refunding and Exchange Contract, under which the Syndicate agreed to undertake to effect the exchange of the new refunding bonds for such outstanding bonds of the City as might be surrendered in accordance with the refunding plan, and the City agreed to authorize the issuance of the new bonds (R. 79a). The City agreed to effect the exchange of bonds solely through the Syndicate, and the Refunding and Exchange Contract gave the Syndicate the right to charge holders of the old bonds, who desired to make the exchange, a fee of 1% of each new bond issued in exchange (R. 79a). The contract gave the Syndicate the right to buy and sell and otherwise deal in both the old and new bonds for its own account (R. 80a).

The refunding plan called for the refunding of bonds of various issues of the City aggregating $131,064,000, which bore interest at rates varying from 4% to 4½% and which matured at various dates from February 16, 1952, to August 1, 1977, but which were callable during the years 1942 to 1947, inclusive. Under the plan the new bonds, to be issued in series, provided for interest at the rate provided in the old bonds until the first optional call date of the old bonds, and provided for interest at reduced rates varying from 2¼% to 3¼% thereafter (R. 80a). The optional call dates of the new bonds were

later than such dates provided for in the old bonds except Series "M" which was not callable, and the maturities of the new bonds were shortened to dates between January 1, 1949, and January 1, 1973 (R. 80a, 81a).

The new bonds were issued in both coupon and registered form (R. 81a). The new bonds in coupon form had attached thereto two types of coupons designated respectively "A" and "B" (R. 81a). The "A" Coupons represented interest during the life of each new bond at the reduced rate provided for in the plan (R. 81a). The "B" Coupons represented the difference between the rate of interest of each old bond and the new reduced rate of interest, and ran from July 1, 1941, until the respective first optional call dates of the old bonds (R. 81a). The purposes of the two sets of coupons were, first, to provide for reductions in the interest rates only after the first optional call dates of the old bonds, and second, to make it possible for investors to detach the "B" Coupons and thus have instruments carrying single rates of interest which would be familiar to investors and which would enable the bonds to be traded in the market, thus providing inducements to the holders to make exchanges desired by the City (R. 81a).

The Syndicate consisted of 39 investment houses and banks located in 9 different states of the Union (R. 76a). The Syndicate arrangements were the subject of an agreement entered into by each member with Drexel & Co. and Lehman Bros. as Joint Account Managers (R. 86a).

During the year 1941 the Syndicate as Agent for the City under the Refunding and Exchange Contract effected exchanges of old bonds for new bonds, and in this connection received commissions in the amount of $367,003.25 (R. 84a). During the year 1941, the Syndicate purchased bonds of the City of Philadelphia in the face value of $15,017,400, for which the principal cost was $17,159,994.59 (R. 84a). The Syndicate during 1941 ex-

changed the old bonds which it had purchased for new bonds in coupon form, that is, with "A" and "B" Coupons attached. As sufficient blocks of bonds accumulated during the year, notice was given to members of the Syndicate that the bonds were available for sale, and notices of offerings were prepared and circulated among members of the Syndicate (R. 84a, 85a). The bonds were offered by the Syndicate without the "B" Coupons attached. Because of the impracticability of distributing the large number of varying types of coupons pro rata to each of the 39 members of the Syndicate, arrangements were made with The Philadelphia National Bank that at intervals when sufficient detached "B" Coupons were on hand, The Philadelphia National Bank would discount them on a 1¼% basis (R. 85a). During 1941 the Syndicate discounted with The Philadelphia National Bank coupons having a face value of $666,896.65 and received from The Philadelphia National Bank the sum of $647,630.38 (R. 85a). The Syndicate received the face value of "B" Coupons maturing January 1, 1942, in the sum of $15,314.22, which the Respondent conceded were tax exempt (R. 85a, 90a, 94a). During the year 1941 the Syndicate sold all of the bonds of the City of Philadelphia which it purchased and the proceeds from such sales totaled $16,517,164.46 (R. 85a, 86a). All of the City of Philadelphia bonds purchased by the Syndicate were purchased at substantial premiums above par, with the exception of a few bonds that were callable within six months on which the premium was relatively small, and all of the bonds which the Syndicate sold during 1941 were sold at substantial premiums above par (R. 86a).

Proceeds which the Syndicate received during the year 1941 from the collection and sale at discount of "B" Coupons in the amount of $662,944.60 were reported in the Syndicate's return for that year as tax exempt interest (R. 77a). The partnership of Drexel & Co. which had a 4% interest in the operations of the Syndicate

showed its share of such amount as tax exempt interest in its return for the calendar year 1941 in which the operations of the Syndicate were reflected (R. 75a). The Petitioner in his individual income tax return for the calendar year 1941 reported income from the partnership of Drexel & Co. as shown on the schedule of distributable shares of income filed with the return of Drexel & Co. (R. 74a, 75a).

The Respondent determined that the proceeds from the discount of "B" Coupons in the amount of $662,944.60 should be added to the net income of the Syndicate, and that as a result the partnership income of Drexel & Co. should be correspondingly increased because of its interest in the Syndicate, and that the Petitioner's income should be increased because of his interest in Drexel & Co. (R. 87a, 88a). At the trial in the Tax Court the Respondent conceded that $15,314.22, representing the face value of "B" Coupons maturing January 1, 1942, should not be added to the Syndicate income (R. 90a, 94a). The Respondent's contention was upheld by the Tax Court which found a deficiency in the Petitioner's income tax for the year 1941 in the amount of $3,960.98 (R. 97a). The decision of the Tax Court was affirmed by the Circuit Court of Appeals for the Third Circuit on March 4, 1946 (R. 106).

WHEREFORE, your petitioner respectfully prays that the petition be granted.

OWEN BIDDLE,
JESSE R. FILLMAN,
CASPAR W. B. TOWNSEND,
WM. CLARKE MASON,
Counsel for the Petitioner.

JUNE, 1946.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

OPINIONS BELOW.

The opinion of the Circuit Court of Appeals (R. 98-105) has not yet been reported. The opinion of the Tax Court is reported in 3 T. C. 829. It is also printed in the Record beginning at page 72a.

JURISDICTION.

The judgment of the United States Circuit Court of Appeals for the Third Circuit was entered on March 4, 1946. The jurisdiction of the Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, chap. 229, Sec. 1, 43 Stat. 938; 28 U. S. C. A. Sec. 347(a).

STATUTE INVOLVED.

Section 22 of the Internal Revenue Code (53 Stat. 9; 26 U. S. C. A. Sec. 22) provides in material part as follows:

> Gross Income—
>
> • • • • • • •
>
> (b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> • • • • • • •

(4) Tax-free interest.—Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; * * *.

STATEMENT.

The facts upon which the Petitioner makes application for the issuance of a writ of certiorari are stated in the foregoing Petition for Writ of Certiorari. In so far as may be necessary for clear understanding of the ensuing argument in support of the Petition, these facts will be supplemented by further references to the Record.

SPECIFICATIONS OF ERROR.

The errors which the Petitioner intends to urge are that the Circuit Court of Appeals erred:

1. In holding that the Petitioner's share of the proceeds of sales by the Syndicate in 1941 of "B" Coupons not maturing until after January 1, 1942, constituted income taxable to the Petitioner.

2. In failing to hold that the proceeds of such sales constituted interest exempt from tax under Section 22 (b)(4) of the Internal Revenue Code.

3. In failing to hold that the Respondent's imposition of income tax on the proceeds of such sales effected an unconstitutional impairment of the borrowing power of the City of Philadelphia.

4. In affirming the decision of the Tax Court.

ARGUMENT.

1. The Syndicate of which the Petitioner's partnership firm was a member, detached specially designated "B" unmatured interest coupons from municipal bonds and discounted the coupons with a bank. The Court below has held that the proceeds did not constitute interest exempt from income tax under Section 22(b)(4) of the Internal Revenue Code, *supra*, page 9, but were the proceeds of "a bargain of a right to receive certain moneys in the future from the City" (R. 103). The decision below ignores an important principle of income tax law which has been established by decisions of this Court, relating to anticipatory dispositions of rights, or the evidence of rights to receive income. This Court has held that a gratuitous assignment of a right to receive income is not effective to prevent taxation of the income to the assignor (*Helvering* v. *Horst*, 311 U. S. 112), and that such an assignment made for a consideration does not change the character of the income in the hands of the transferor. *Hort* v. *Commissioner*, 313 U. S. 28. These rules are grounded upon the reasoning of numerous decisions of this Court. See for example, *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136; *Griffiths* v. *Helvering*, 308 U. S. 355; *Harrison* v. *Shaffner*, 312 U. S. 579. The breadth and importance of the rules can be seen in their application to income in the form of interest (*Helvering* v. *Horst, supra*); to rental income upon the cancellation of a lease (*Hort* v. *Commissioner, supra*); to dividends sold (*Gibson* v. *Commissioner*, 133 F. (2d) 308 (C. C. A. 2d)); to trust income realized through the sale of a life interest (*Beulah Eaton McAllister*, 5 T. C. 714); to compensation received through the sale of stock options (T. D. 5507; I. T. 3795, Int. Rev. Bull., April 22, 1946, pp. 2, 3); to rights to in-oil payments assigned while the oil is still in place (G. C. M. 24849, Int. Rev. Bull., March 11, 1946, p. 4). See also,

Commissioner v. *Tower,* No. 317, this Term. The Court below failed to perceive the pertinence of the principle above discussed, and instead relied heavily upon *Clyde C. Pierce Corp.* v. *Commissioner,* 120 F. (2d) 206 (C. C. A. 5th) involving the unrelated situation of bonds with interest coupons in default which were purchased for a "flat price". A proper recourse to decisions of this Court leads, we submit, to the conclusion that the proceeds from the disposition of the interest coupons were interest when received and as such were exempt from income tax under the statute.

Is a taxpayer to be deprived of the exemption which attaches to municipal bond interest simply because he realizes on the interest coupon prior to its accrual? This question we submit should be answered in the negative under principles laid down by this Court.

The error in the result reached by the Court below is emphasized by the fact that the exemption in cases such as the one at bar is altogether lost. If the Petitioner is denied exemption, through the Syndicate and his partnership firm, no one will obtain any benefit from the statutory exemption because the purchaser of the coupons is entitled to recover the investment made and has no need of the exemption (except to the extent of the discount which of course was not received by the Syndicate).

The case at bar presents a question of importance in the administration of the income tax. The Syndicate consisted of 39 investment houses and banks located in 9 different states of the Union (R. 76), and consequently involves a great number of taxpayers. Aside from the number and geographical location of the taxpayers involved in the Syndicate in this particular municipal financing operation, the case assumes importance because of the recent wide use of municipal refunding plans calling for two separate series of interest coupons. The first instance of the use of such a plan appears to have been in the case of the Independent School District of Des Moines,

Iowa (R. 27a) which was adopted November 6, 1940, and made provision for the exchange of $5,140,000 of outstanding bonds for refunding bonds with two sets of coupons. The Petitioner is informed that the following political subdivisions of states have adopted plans which have made use of coupons corresponding to the A and B coupons used in the Philadelphia refunding:

Chattanooga, Tenn., June 1, 1941, to refund $6,135,000 of bonds;

County of Nassau, N. Y., July 27, 1942, to refund $5,660,000 of bonds;

Atlantic City, N. J., June 1, 1944, to refund $12,918,000 of bonds;

Township of North Bergen, Hudson County, New Jersey, May 1, 1945, to refund $5,533,000 of bonds;

Margate City, Atlantic County, N. J., June 1, 1945, to refund $2,306,000 of bonds.

In each of the above plans, the Petitioner is informed that provision was made under which one set of the coupons could be detached so as to provide instruments carrying a single rate of interest which was one of the purposes of the provision in the Philadelphia refunding.

2. In the circumstances of the case and of the refunding plan of the City of Philadelphia out of which the case arises, it is submitted that the imposition of income tax upon the proceeds from the disposition of the interest coupons imposes a burden upon the power of the City to borrow money and destroys a substantial measure of protection which is intended to be afforded the municipality under the Constitution. *Pollock* v. *Farmers' Loan & Trust Company,* 157 U. S. 429; *id.,* 158 U. S. 601. As the record shows, the City was enabled to refund many bonds which but for the operations of the Syndicate would not have been offered for exchange (R. 28a, 29a). The tax imposes a direct burden upon the refunding operations of the City and is therefore invalid under the Constitution.

CONCLUSION.

The case at bar presents an important question in the administration of income tax law which was incorrectly decided by the Court below and which should be decided by this Court. A substantial question of the constitutionality of the imposition of the tax involved is also presented. The petition should therefore be granted.

Respectfully submitted,

OWEN BIDDLE,
JESSE R. FILLMAN,
CASPAR W. B. TOWNSEND.
WM. CLARKE MASON,
Counsel for the Petitioner.

JUNE, 1946.